

**Lee N. Price and Douglas S. Rogers' response to GIPS Executive Committee's (EC) invitation to comment on proposed GIPS 2010 Exposure Draft:**

May 7, 2009

CFA Institute  
Centre for Financial Market Integrity  
Reference: Global Investment Performance Standards  
P.O. Box 3668  
Charlottesville, Virginia 22903

Dear Sirs:

The purpose of this response is to address the statement that "country-specific guidance on taxation issues has been removed from the Standards and will be addressed separately" in the invitation to comment to the Exposure Draft of the 2010 Global Investment Performance Standards (GIPS). This response has been prepared by the Chairs of the two AIMR sub-committees for after-tax return reporting, Lee N. Price, Ph.D., CFA and Douglas S. Rogers, CFA.

Since the first sub-committee was formed in the early 1990's great progress has been made in the understanding and practical application of after-tax return reporting. The United States investment management industry led the pioneering effort that was strengthened by the Securities and Exchange Commission (SEC) mandating after-tax return reporting for most mutual funds. The concern being raised by the Chairs is that unfortunately the effort directed at after-tax returning has not progressed since the last subcommittee for after-tax reporting and the decision to remove after-tax reporting standards from GIPS we believe will prove to be a major disservice to taxable account practitioners. This is troubling, since it is estimated that approximately half of the world's liquid financial assets are subject to taxation.

There were three primary objectives of the first subcommittee. The first was to identify a single standard methodology to adjust pretax investment for the taxes which might be expected to be paid by a taxable investor. This was critical because numerous investment advisors were reporting what they called "after-tax performance" while using methodologies which varied from simply taxing dividends to a complete liquidation approach to complicated methods of estimating future taxes on even unrealized capital gains and losses. The second objective was to assure that the approved after-tax calculation could be applied to a single portfolio even though most of GIPS was oriented to the reporting of performance for composites. The third objective was enable a methodology to adjust composite performance for non-discretionary withdrawals of capital from a portfolio which resulted in capital gains which were not intended or controlled by the manager.

The first objective was met by committee approval of the "realized basis" methodology (referred to as pre-liquidation by the SEC) whereby all taxes are assumed to be paid at the time the dividend or interest income or capital gain/loss is realized. The second object was met by committee approval of the phrase "in accordance with AIMR PPS after-tax standards," as applied to the footnotes for an individual

portfolio, even if a composite is not created. The third objective was met by an admittedly complicated calculation which was published and has been used by numerous vendors to adjust after-tax composite performance for non-discretionary withdrawals as a function of the size of withdrawal and percentage of unrealized gains in the portfolio at the time of withdrawal. All of these committee recommendations were accepted and adopted by the AIMR PPS committee and full AIMR Board and were later added to GIPS.

The second subcommittee for after-tax return reporting was formed with two objectives. The first objective came about as a result the SEC requesting then AIMR to comment on the anticipated release of the public comment document for after-tax reporting standards for mutual funds. As often said by James Hollis, the Chair of AIMR Implementation Committee, "a blue ribbon panel of experts was established to address this timely issue." Industry professionals with relevant experience were assembled that included noted tax policy expert James N. Poterba, D.Phil. After this objective was satisfied, which included a meeting by invitation with the SEC at their headquarters, the subcommittee directed their attention to addressing the second objective of revisiting the existing AIMR after-tax reporting standards to recommend proposed changes. This was a necessary logical step, since taxable account practitioners were suggesting potential revisions to enhance the original effort.

There were four items of note emphasized by the AIMR staff as the 2<sup>nd</sup> subcommittee went about their work.

1. The first item was that, as much as possible, recommendations to the AIMR after-tax reporting standards for separate account composites should be consistent with the provisions of the SEC standards for mutual funds. An example is that the treatment of taxes would take place at the time of taxable event. For a separate account the impact is at the time income is received (whether from dividends or interest or from the selling of a security which results in a realized a gain or loss), whereas with a mutual fund it is at the time of distribution. In recent discussions with individuals directly involved in GIPS, it is apparent that the importance of duality has obviously been lost. The objective of consistency was achieved with one noted exception. It was decided by the after-tax subcommittee that the SEC requirement for post-liquidation after-tax returns should not be required for separate account composites, because cash flows in and out of composites had the potential of creating misleading results.
2. The second item was the after-tax standards for separate account composites had to be consistent with the anticipated GIPS provisions. An example is that no assumptions were allowed in calculating after-tax returns, such as estimating a portfolio's internal rate of return to establish an estimated tax for unrealized capital gain and loss positions.
3. The third item was to attempt to achieve a mathematical formula to address a manager's or fund's tax-efficiency or lack thereof. The subcommittee succeeded in achieving this task by developing the relative wealth measure. Soon thereafter, the measure was modified by Morningstar to create their "tax-cost ratio" which is widely applied today for mutual fund after-tax performance analysis.
4. The fourth item that was strongly encouraged by the AIMR staff was to document the history and rationale for the subcommittee's recommendations. A great deal of time and effort was

spent by the subcommittee so that other countries following the initiative of the United States would benefit from the pioneering effort and could efficiently gain an understanding of critical academic concepts and requirements so that they could incorporate the tax code of their country and be consistent with GIPS.

Over the years Lee Price and Doug Rogers have given numerous presentations highlighting the after-tax return provisions. They have shared the critical elements both in the United States and other countries. Moreover, Doug Rogers was specifically asked during his exit interview when his term of service expired what he believed needed to be done to further the adoption of after-tax reporting standards by other countries. He reiterated what had been shared with James Hollis earlier that the charge of the next GIPS Committee should be to review the United States after-tax reporting standards and extract and document specific criteria that should be required of any country adopting after-tax knowing that their country's tax regime would be different. Examples of these criteria include:

- Taking into account taxes at the time of the taxable event.
- Adhering to provisions of the tax code that are applicable to the specific client type, e.g. individuals, property and casualty insurance companies, nuclear decommissioning trusts, etc.
- Returns should be net versus gross of taxes, e.g. a tax-exempt bond return should not be adjusted to a taxable bond equivalent.

The hope was that a working template could be developed to facilitate efficient development of specific country standards taking into account accounting differences but ensuring GIPS oversight and approval. It is disappointing to say the least that there was no follow through on this recommendation. Even more disappointing is that it appears the Executive Committee of GIPS has already removed the after-tax standards from GIPS without consultation of the previous Chairs or putting the concept out for public comment.

It is the recommendation of Lee Price and Doug Rogers that after-tax reporting standards not be dropped from GIPS. Moreover, we are recommending that individuals be appointed with a vested interest in the furthering of after-tax reporting standards and be charged with developing the key criteria necessary and a working template so that future generations will benefit from the inclusion after-tax provisions in GIPS. Additionally, those responsible for overseeing the GIPS staffing should ensure that an individual with a working knowledge of the after-tax provisions is a member of appropriate committee(s).

We strongly encourage the GIPS Committee to retain and eventually expand the after-tax performance standards which are widely in use, not only in the United States and Canada but also in Australia and numerous other countries.

Sincerely,

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Douglas S. Rogers, CFA